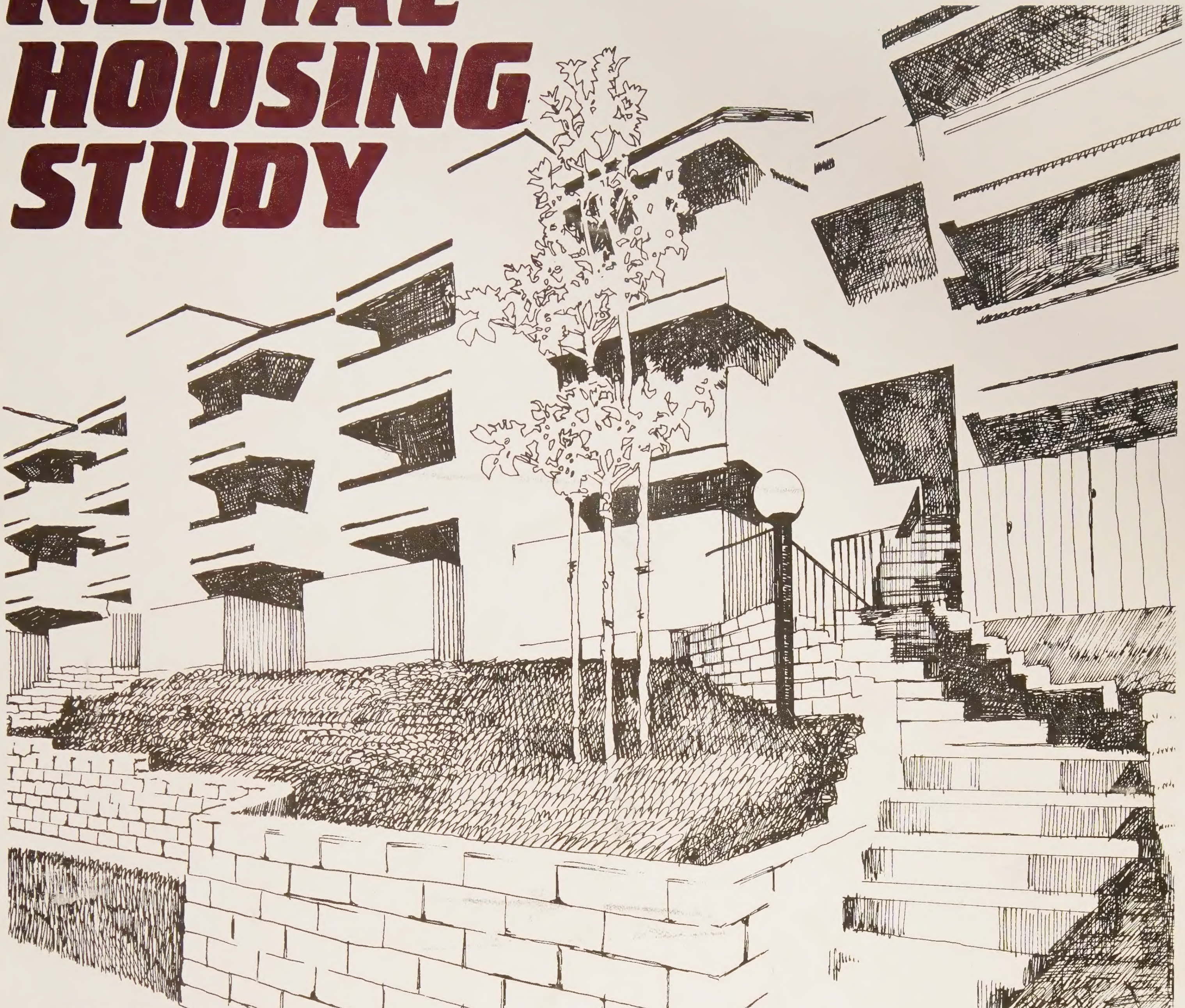
RENTAL HOUSING STUDY



1984 CITY OF LOS ANGELES RENT STABILIZATION DIVISION

EXECUTIVE SUMMARY

1984 RENTAL HOUSING STUDY

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Inglewood
Long Beach
Pasadena
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County of Los Angeles

Assessor's Office

Southern California Association of Governments

State of California

Franchise Tax Board

United States Government

Department of Labor
Bureau of Labor Statistics

Bureau of the Census

Department of Housing and Urban Development

Private Industry

Southern California Gas Company

Security Pacific National Bank

Institute of Real Estate Management

Society of Real Estate Appraisers

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RENTAL HOUSING IN LOS ANGELES:
DATELINE 1985

Executive Summary

Making sensible public policy with respect to the rents charged on mutifamily dwellings is among the most demanding challenges faced by urban governments. The commodity involved -- shelter -- is a basic necessity. The people directly involved, both tenants and property owners, comprise a large proportion of the total population. The economic implications of the rents charged and the returns on investment received are crucial at all levels of concern, from family budgets to the overall health of the local economy. Small wonder that these issues generate deep convictions and high emotions, and that both are forcefully expressed in the political process.

This is as it should be. The policy choices to be made are never entirely determined by facts or technical analyses, however sophisticated. The decisions must express value judgments that are necessarily subjective in nature. Though a quantitative formula can reflect and implement a policy, no adequate policy can be set or explained if such a formula is regarded as anything other than an instrument to achieve the balance among fundamental values that underlies it. Valid public policy must be rooted in the substantive aims of a society; facts, analyses and policy instruments will not in themselves decide basic issues.

Having accepted this, however, there remains a critical role for fact-gathering and analysis. Value judgments can be translated into effective policy only if policy-makers are as informed as possible about the factual context and the likely impact of the options open to them.

The Mayor and City Council of Los Angeles recognized this in November 1983, when they directed the Rent Stabilization Division of the Department of Community Development to direct a thoroughgoing study of the rental housing market and the impacts of the rent stabilization program that had been in effect since 1979. The mandate from the Mayor and Council specified three broad target areas for study:

* A documented basis for an objective formula for adjusting the maximum annual rent increase for rent-stabilized units that is permitted by the City's Rent Stabilization Ordinance.

* Possible alternative methods for directing the benefits of rent stabilization to low income and senior citizen tenants.

* Development of statistically reliable information on a range of factors concerned with the economic and financial effects of stabilization on tenants, on property owners, and on public revenues, as well as measures of housing condition and construction, and various indicators of housing market performance.

Working with a Steering Committee composed of representatives of property owners, tenant groups, organized labor and other knowledgeable parties, the Division subsequently devised a carefully crafted Request for Proposals, reviewed the bids received, and in September 1984 awarded a study contract. The Division elected to perform the new construction and housing market performance aspect of the study internally. For the study of the impacts of and possible alternatives and supplements to rent stabilization, it contracted with a consortium led by Hamilton, Rabinovitz, Szanton and Alschuler, Inc. (HRS&A) and the Urban Institute. This Executive Summary covers both the work performed in-house and that performed by HRS&A/Urban Institute.

The work summarized here involved a large number of different data collection and analytic efforts involving many technical tools and methods. All of these are described in the body of the Report and presented in further detail in the Technical Appendices. The reader interested in technical data or detailed findings is invited to review those documents. This Summary will concentrate solely on highlights of the substantive findings.

The Historical Context

Few periods in the peacetime history of the American economy have been as unsettled and unpredictable as the period since the enactment of rent stabilization. The year of enactment was the year of the second world oil shock, which sent petroleum prices soaring. It was also the year after Proposition 13, which made drastic changes in the cost structure of property ownership while simultaneously revolutionizing California public finance. The first years of implementation of the Rent Stabilization Ordinance came during America's introduction to double digit inflation, which saw the Consumer Price Index for the Los Angeles area peak at an increase of 15% for a single year. Interest rates gyrated to a degree that Americans had not experienced for half a century. Battered by inflation, the economy then plunged into the deepest downturn since the Great Depression. Unemployment surged and, although inflation abated, interest rates remained stubbornly high. Finally, months and even years after all previous experience would have predicted recovery to start, the economy recovered and achieved high rates of growth with only very moderate rates of inflation.

This is the pitching economic platform upon which one must try to assess the effects of rent stabilization in Los Angeles. Upheaval was the norm, stability the exception. The role played by any policy intervention in the context of this maelstrom of change and counterchange is necessarily difficult to establish. Moreover, the significance of history to future experience is more questionable than would be the case if the economic scene had been relatively quiescent. Even if we can establish what effects were achieved in the past, the future may provide a very different milieu.

The upshot of this history is to encourage a certain humility in both writing and reading generalizations about the probable effects of rent stabilization policy. What can be learned from careful data collection and analysis has been

learned, in our judgment. But it is well to remember that there were many currents in those stormy economic seas and much depends upon whether they come again or are replaced by others just as unfamiliar.

General Evolution of the Rental Housing Market Under Stabilization

This study concludes that rent stabilization has had little if any effect on the average rate of increase in rents (including utility costs) paid by City tenants as compared with those in cities contiguous to Los Angeles which practice no form of rent regulation. The average rate of increase in the City during the period since stabilization was enacted has been 10.9% per year, compared to 11.1% in surrounding unstabilized areas. The difference represents well under one percent of the income of tenants in stabilized units.

When this difference between average stabilized and unstabilized rents is converted into savings on monthly rent bills, it translates into a modest $7 per household per month. If one believes that the proper measure of what Los Angeles rents would be if there were no stabilization is not the rents charged in surrounding cities but the rent charged for vacated apartments in the City (which are not regulated by law), then the savings from rent stabilization to all tenants taken together works out to an only slightly more imposing $18 per month. Put another way, the evidence indicates that under the Los Angeles form of rent stabilization, only very modest subsidies have flowed from all landlords to all tenants.

Nevertheless, sizeable subsidies do in fact flow to some types of tenants. The analysis indicates that these subsidies are financed in part by other tenants who pay premiums above what their rents would be if stabilization had not been enacted. By far the most important determinant of which tenants are subsidized and which pay premiums is the length of time that a household has remained in its rental unit. If the household has not moved at all since enactment of rent stabilization, the subsidy

averages $47-$55 per month. On the other hand, if the household moved during 1982-83, the study indicates that it is paying an average premium of $15-$28 per month more in rent than it would be charged for the same unit if rent stabilization had not been adopted.

The primary vehicle for the subsidy flow is the markup charged to an incoming tenant renting a vacant apartment. Since the current rent stabilization ceiling on increases charged to tenants who do not vacate is and has always been 7% (plus an allowance if the landlord pays utility costs), the only means by which average rents across the City can keep up with average unstabilized rents in the metropolitan area is to make the markups on vacated units much higher. The data suggest that the average markup in the City in 1984 was 14%, and that markups in 1982 and 1983, when double digit inflation was fresh in everyone's mind, were much greater. Thus, it is not the households who have moved most recently who finance the bulk of the subsidy to long-tenured households, it is those who moved 1-2 years ago.

There are certain demographic characteristics associated with long- and short-tenured households, respectively. Those who have stayed in their units longest tend to be smaller households, of low to moderate income, housed in smaller buildings, composed of older members and less often comprised of members of a racial/ethnic minority than households that have moved. But both types of households include examples of all demographic types. Thus, for example, one-third of the senior citizen households in stabilized units do not fall into the long-tenured group, and about one-quarter of the households that are long-tenured have incomes of more than $40,000 per year. Thus, although by distributing subsidy largely according to tenure the stabilization program does subsidize many who might be classified as needy or otherwise deserving, it does not reach all of them by any means, and it does subsidize some who may not be intended beneficiaries.

The net overall effect of stabilization seems to have been to permit 12-25,000 Los Angeles households to keep their housing costs lower than standard measures of affordability (i.e., 30% to

40% of total household incomes) when their current housing would not be in this affordable range without stabilization. However, one must emphasize that this a net outcome, meaning that the subsidizing effects of stabilization have moved that many more households into the affordable range than the number of households that the program has moved out of the affordable range by generating premiums above the rents that would be charged if the program did not exist.

Turning to the effects of the programs on the owners of stabilized rental properties, the analysis concludes that, taken on the average over the entire period of stabilization, their financial experience has been only slightly less remunerative than that of owners of unstabilized properties in contiguous areas. But that result was not achieved smoothly. The rates of return to landlords in the years immediately following the enactment of stabilization dipped noticeably. In recent years, however, returns have been increasing at higher rates than in surrounding areas, so that the average net financial effect on owners who have held onto their properties throughout the stabilization period have been modest. This confirms the finding that landlords as a whole do relatively little subsidizing of tenants taken as a whole. But with landlords, as with tenants, it is important to remember that this is what has happened on the average, not necessarily what has happened to any particular individual.

The behavior of rental housing construction and reinvestment during the rent stabilization period follows the same general profile as landlord finances. Total new construction fell by almost two-thirds during the period 1978-82, and then rebounded sharply to a new peak in 1984. Capital improvements have been sustained, although those supported by rent increases specially granted under the terms of the Ordinance have been concentrated in the larger buildings. Of course, one must remember that the construction and reinvestment markets have been buffeted and constrained by interest rate changes and other factors that have little if anything to do with rent stabilization. Still, the

pattern suggests that these markets have now discounted both for stabilization and for their perceptions of the likelihood of massive changes in City policy, and the flow of investment funds has recovered accordingly, despite interest rates that continue to be very high by historical standards.

Just as important as the measurable effects of rent stabilization on the rental housing markets are the phenomena upon which it has had no measurable effect. To take the leading examples revealed by the study:

* Households are moving only about half as often now as they were five years ago, but this is just as true in unstabilized cities as in Los Angeles.

* Vacancy rates in Los Angeles were low when stabilization was enacted and they remain low (1.5%-3.5%) now, running about half a percentage point lower than in surrounding areas.

* The ratio of people to rooms is rising (i.e., more people are being housed in fewer rooms), but this is true to about the same degree in stabilized and unstabilized areas.

* Housing is becoming less affordable (i.e., the ratio of rent to household income is rising), but not noticeably faster in the City than in surrounding unstabilized areas.

* The incidence of units perceived to be in need of repair is rising, but, again, no faster inside the City than in jurisdictions that do not regulate rents.

* Perceptions of the quality of the neighborhoods where rental housing is located are at least holding firm and seem to be becoming a bit more positive inside and outside the City.

In short, in many crucial areas there is no evidence that rent stabilization has made any measurable difference in the evolution of the rental housing market. The measures are far short of perfect, and many trends are unfavorable regardless of whether rent stabilization is the cause. Nevertheless, it is important to know what this particular aspect of municipal policy does not seem to be affecting as well as what it does seem to influence.

Tenant Perceptions of Rent Stabilization

Among all of the general and specific information gathered with respect to the perceptions of tenants whose rents are stabilized, two findings stand out.

First, the data indicate that the members of two in every five households in the City of Los Angeles do not know whether rent stabilization does or does not apply to their dwellings. Despite more than six years of vigorous policy debate, intense media coverage, and extended public argument of the issue, 41% of all of the tenants contacted in a statistically representative random sample of City tenants responded that they were unaware whether rent stabilization applied to their units.

Second, the study concludes that, among those tenants who feel equipped to respond to questions about the financial benefits that rent stabilization confers upon them, more than eight out of 10 believe that it is saving them a great deal of money, and virtually none of them believe that it is in any way harming their interests. Far from the modest net subsidy that the analysis shows is being delivered to all tenants as a whole, the tenant estimates of their savings add to a total seven to 20 times as great. The fact that a substantial number of tenants may be paying premiums above what their rents would have been absent stabilization does not seem to have entered the public consciousness.

Of course, not all of the perceived benefits of stabilization can be translated into money terms. The study confirmed that the single benefit that tenants perceive and prize most is stability in their rents. Still, the discrepancy between prevailing tenant perceptions of the financial effects of rent stabilization and what the numbers suggest is actually happening could hardly be more striking.

Alternative Adjustment Formulas

The study analyzed the probable effects of six approaches to regulating the maximum rent increase that would be permitted by the Ordinance to be charged to a tenant household that had not vacated its unit. The first was the continuation of the flat 7% ceiling that is now in effect. The other five would permit the ceiling to vary from year to year according to (a) general price inflation, as measured by the Consumer Price Index (CPI); (b) the portion of the CPI that refers to prices of goods and services other than housing: (c) the fraction of the CPI that corresponds to the ratio of average operating costs plus profit to building income; (d) the actual average increase in building operating costs; and (e) the "fair" rate of return as measured by yields on competing investments.

With respect to the flat 7% ceiling, the analysis indicates that, although it may never have simulated the behavior of prices in any given year, averaged over the entire period that rent stabilization has been in effect, the effect of the ceiling has been roughly the same as would have occurred if rent increases had been permitted to rise by the change in the CPI. At present, however, it permits increases that are much higher than any measure of the current inflation rate, whether considered in general terms or in terms of building-related costs. Whether it will do so in the future depends upon whether one expects future price trends to resemble those of the last two years or those we experienced 4-6 years ago.

As to the last type of formula listed above, the one that would vary by a "fair" rate of return measured by the yield of competing investments, the analysis indicates that no competing yield tested would exceed the combination of operating profitability and capital appreciation that has been experienced by Los Angeles stabilized properties averaged over the years since stabilization was enacted. Thus, since the rate of return on the other investments used as a standard was lower than the return on these properties, any formula based on this difference would

require regular decreases in the amount of rent charged to non-moving tenants. This would put severe strain on the financial viability of most buildings unless one believes that landlords would tolerate negative cash flow for most years prior to the one in which they sold the property.

The other four formulas break into two distinct types: those that vary with the general price index and those that vary with some measure of trends in building costs. The analysis indicates that the two formulas within each type track each other very closely. The basic difference between the two types under current cost and price conditions is that those based on cost measures would permit rent increases just under 60% as great as those based on the price index. If 1985 inflation experience is similar to 1984 experience, none of the four formulas would permit rent increases nearly as high as would continuation of the 7% flat ceiling. The cost-based formulas would permit 1985 raises of about two and one-quarter percent, while the price-index based formulas would allow maximum increases of about 4%.

Accordingly, the formulas based on the behavior of building costs would provide lower rents to tenants who stay in place, and the formulas based on the price index would generate more rental income to landlords. The differences in subsidy received by different tenure subgroups of tenants would not be likely to make different subgroups prefer different formulas, however. Although the amount of benefit (or avoidance of higher premiums above unstabilized rents) would vary from tenant to tenant, the degree to which a particular formula was more beneficial to them than another formula would not be expected to vary.

The formulas would differ substantially in relative ease of administration. Those based on indices of the behavior of building costs would require a reliable and regularly updated base of data about trends in those costs. Formulas based on general price indices, on the other hand, would require no such data base and would require that only one number be determined each year from a readily available national index compiled at another level of government.

Alternatives and Supplements to Rent Stabilization

The study analyzed three optional types of subsidy programs that might be substituted for rent stabilization in an attempt to direct equivalent financial benefits to low income and senior citizen households. These included a housing voucher program on the model of a Federal experiment, a series of subsidies to new construction (including rent supplements to needy and elderly tenants), and a program of conversion to cooperatives owned by low and moderate-income households. In order to approximate the net benefits now delivered to the target beneficiary groups by rent stabilization, these programs would need to provide total subsidies in the range of $83 million to $173 million per year, depending upon which standard of measurement were adopted to measure net benefits.

The analysis of optional programs emerged with the consistent conclusion that, even if funded at the levels just mentioned, all would face a tradeoff between providing a relatively small amount of help to every household in the beneficiary groups or bringing a relatively small minority of them up to widely accepted affordability standards for housing. This reflects the fact that, whatever its other effects, rent stabilization has not brought the housing costs of all -- or anything like all -- needy and/or elderly Los Angeles renter households into the affordable range. Alternative subsidy programs funded at these levels could make a visible dent in the affordability problem, but they could not begin to solve it unless much larger amounts were made available.

The study also examined nine possible ways of raising the money needed to fund the optional programs, including a number of options designed to supplement rather than replace rent stabilization, from within the rental housing industry. These techniques ranged through a variety of specialized taxes levied on tax bases of varying breadth and depth. Although the tax rates necessary to generate the needed amounts varied a great deal from

option to option, all of the rates generated were much higher than those that have traditionally been imposed in Los Angeles, so that all would be very sharply felt.

The Road Ahead

This study attempts to provide facts, figures and analysis necessary for City officials to consider one of the most important and contentious sets of policy issues now facing them. It is impossible in these brief highlights to do full justice to the breadth of material generated by the effort. The reader with policy responsibility or other serious interest is urged to review the entire Report and supporting documents. Many critical findings can only emerge in the context of finer detail. In view of the importance of the policy decisions that must be made, we believe that a further investment of the reader's time would be well rewarded.

In looking forward, it is often useful to first look backward and survey the road that has been traveled. As these highlights should have made clear, the overall picture in the rear-view mirror is one in which the Los Angeles rental housing market has traversed peaks and valleys to emerge at roughly the point that it would have reached without rent stabilization. The policy has made a major difference in the distribution of the rent burden among tenants, and in the financial impact on property owners in any year or succession of years, but a changing economic context has tended to even out these fluctuations over time. It is arguable that a change in policy at any point during the past six years would have severely disadvantaged one interested group or another, whereas a change now would start with each group in relatively healed condition.

Whether or not this is true, however, the changed economic climate seems likely to spur demands for an early policy decision. It is our most earnest hope that the work summarized herein will be of genuine and continuing use to those who must make this fateful choice.